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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 176

WILLIAM E. HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

No. 177

EULA DAY HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 13) has not been officially reported. The opinion of the Circuit Court of Appeals (R. 37) is reported in 70 F. (2d) 785.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on April 24, 1934 (R. 46, 52). A petition for rehearing was denied June 8, 1934 (R. 47). The petition for writs of certiorari was filed July 14, 1934, and granted October 8, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether bonuses paid a landowner, upon the execution of leases permitting exploration for and extraction of oil and gas, are subject to the depletion allowance authorized by paragraph (2) of Section 204 (c) of the Revenue Act of 1926 when there had been no prior oil development on the leased lands, no wells were drilled or under construction during the taxable year, and there was then no practical assurance of future production.

STATUTE INVOLVED

Sections 204 (c) and 214 (a) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 14, 26–27, U. S. C. App., Title 26, Secs. 935, 955, provide in part as follows:

> SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a)[1] or (b)[1] for the purpose

[1] Section 204 (a) provides that the basis for determining the gain or loss from the sale or other disposition of prop-

of determining the gain or loss upon the sale or other disposition of such property, except that—

(1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reason-

---

erty acquired after February 28, 1913, shall be the cost of such property, with exceptions immaterial here. Section 204 (b) provides that the basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be the cost of such property (with exceptions immaterial here) or the fair market value of such property as of March 1, 1913, whichever is greater.

able allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

STATEMENT

The petitioners, who are husband and wife, filed separate income-tax returns for the year 1926 under the Texas community property laws. They hold a 50% interest in a partnership which owns several ranches near Amarillo, Texas. In 1926 the partnership, which was principally engaged in the business of cattle raising, leased portions of its ranches to various individuals and corporations for the purpose of exploring for and producing oil and gas. The partnership received in that year bonuses for these leases totaling $683,793.75. (R. 21–22.) Prior to the leases there had been no oil development on any of the tracts and the nearest oil well was three and one-half miles away (R. 22). The first wells drilled on the partnership land were drilled about 1930 (R. 24). The wells produced gas but not oil; in three there was a favorable or small "showing" of oil; the fourth "made * * * about eight to ten barrels of oil" (*ibid.*).

The partnership lands are in the Texas Panhandle, and Panhandle oil cannot, because of its sulphur and paraffin content, compete with East Texas oil (R. 26). The production in East Texas, or close to Tidewater, will be used before more wells are drilled in the Panhandle, and the East Texas production may last from 7 to 15 years (R. 26, 28). In December 1932, at the time of the hearing before the Board of Tax Appeals, there was no way in which an owner of a gas well in the Panhandle could dispose of his gas (R. 15, 27).

The lease shown in the record, which is typical of the other leases executed by the partnership, provides for the usual royalty of one-eighth of all oil and gas produced, and the lessee can preserve his rights under the lease without commencing any well if he pays a nominal annual rental (R. 22, 31–32). The lease is for a term of 5 years and as long thereafter as oil or gas is produced (R. 31).

The partnership in its 1926 return claimed a depletion deduction of $188,043.28, this amount representing 27½% of its bonus receipts (R. 22). The Commissioner disallowed this deduction, increased the taxable income of the petitioners by their pro rata part of the deduction, and found a tax deficiency of $11,337.29 as to each (R. 2, 10, 22). The Board of Tax Appeals sustained the action of the Commissioner and the Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Board of Tax Appeals (R. 14, 46, 51).

By stipulation, only the record in the case of petitioner William E. Herring has been printed and the decision in that case is to be accepted as the decision in the case of the other petitioner (R. 2).

SUMMARY OF ARGUMENT

The Revenue Act of 1926 authorizes, "In the case of oil and gas wells", an allowance for depletion based upon income from the property. Petitioners are not within the quoted phrase unless "wells" is construed to include a mere grant of authority to drill a well. There is no ambiguity justifying departure from the ordinary meaning of the words used, and the Treasury has consistently construed the statute and the regulations thereunder as not applying to "leases covering properties on which no well is in existence."

The allowance is for "depletion." Depletion allowances have always been recognized as representing deductions allowed to compensate the taxpayer for a wastage or exhaustion of his assets. It therefore cannot be assumed that Congress intended to allow a depletion deduction on account of bonus payments received in a year when there was no production, no well in existence or under construction, and no other facts then existing sufficient to give practical assurance of future production. The character of items as income or as deduction is to be determined by the events of the taxable year.

The foregoing view is not in conflict with *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. There is a marked

difference between a bonus paid to the lessor of a producing or proven tract of land, when the bonus constitutes an advance payment of royalty in anticipation of future production, and a bonus paid for the privilege of executing a lease which in subtance grants the lessee a long-term option to prospect for oil, when it remains a mere speculative possibility whether or not there ever will be any actual depletion.

The Board of Tax Appeals has uniformly held that, under circumstances similar to those presented here, a bonus is not subject to the depletion allowance based upon income authorized by the 1926 Revenue Act. The Circuit Court of Appeals for the Eighth Circuit has reached the same conclusion.

This Court has held that a bonus *may* be subject to depletion. It has not previously had occasion to consider the limitations of the depletion deduction as applied to bonus payments.

If the statute authorizes a deduction whenever the facts existing during the tax year give practical assurance of future production, the decision below should nevertheless be affirmed. Petitioners have failed to establish the facts necessary to bring themselves within the statute so construed.

ARGUMENT

Section 214 (a) (9) of the Revenue Act of 1926 (*supra*, pp. 3–4) allows as a deduction in computing net income from mines, oil and gas wells, and other

natural deposits, a reasonable allowance for depletion, to be made under rules and regulations prescribed by the Commissioner of Internal Revenue.[2] The earlier Revenue Acts (1918, 1921, and 1924) provided that in the case of mines and oil and gas wells the depletion deduction might, under certain conditions be computed upon the basis of "discovery value" rather than cost or March 1, 1913, value.[3] Paragraph (1) of Section 204 (c) of the Revenue Act of 1926 (*supra,* p. 3) limited this allowance to "mines." Paragraph (2) added a new provision permitting a depletion deduction for oil and gas wells equal to 27½% of the gross income from the property during the taxable year, but not in excess of 50% of the net income from the property, with the safeguarding exception that in no case should the allowance be less than if computed without reference to this paragraph. The question presented for determination is whether paragraph (2) permits depletion of a bonus given for executing a lease when there has been no prior oil development on the lessor's land, no well is drilled or started during the year the bonus is received, and there is then no practical assurance of future production.

It should first be noted that the percentage depletion deduction is allowed, "In the case of oil

[2] Substantially the same provisions are found in Section 214 (a) (10) of the 1918 and 1921 Revenue Acts and in Section 214 (a) (9) of the 1924 Revenue Act.

[3] Section 214 (a) (10) of the 1918 and 1921 Revenue Acts and Section 204 (c) of the 1924 Revenue Act.

and gas *wells.*" Petitioners are not within this phrase unless the word "wells" is construed to include the mere grant of authority to drill wells. We submit that, since there is no ambiguity in the language of the statute, the word "wells" cannot properly be construed to mean "leases." For the purposes of this case it is unnecessary to decide whether paragraph (2) applies only where there is a producing well; or where there is a completed, but dry, well; or where there is a well in course of construction; or where there is a well upon the same tract, but not upon the land covered by the lease for which the bonus was received. None of these situations is presented here.

Article 216 (e) of Treasury Regulations 69 (*infra,* p. 22), which deals with the percentage depletion deduction authorized by paragraph (2), provides that the deduction there allowed may be taken by "the lessor of oil and gas wells." In 1927 the following important interpretation of Section 204 (c) (2) and Article 216 (e) was issued (I. T. 2384, VI–2 C. B. 22, Appendix, *infra,* p. 21).

> It will be noted that the above-quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from such property. Accordingly, it must be concluded that the application of article 216 (e) of Regulations 69 is dependent upon whether or not the lease in question is of an

> oil or gas well, and that article 216 (e) of the regulations does not apply to leases covering properties on which no well is in existence.

There appears to be no later published Treasury ruling or decision inconsistent with the above ruling, with the possible exception of G. C. M. 11384, XII–1 C. B. 64 (Appendix, *infra,* p. 21), issued in 1933, reinterpreting Section 204 (c) (2) in the light of *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. Since throughout this period both the law and the Treasury Regulations thereunder remained the same,[4] I. T. 2384 seems to establish a uniform administrative construction which, upon familiar principles, is entitled to great weight. The only portion of G. C. M. 11384 which may possibly be regarded as qualifying I. T. 2384 is the conclusion of the General Counsel that Section 204 (c) (2) permits depletion of a bonus received in a year when there was no oil production, provided future production was then "practically assured because of nearby wells and geological indications."

Section 204 (c) (2) not only limits the deduction there authorized to cases of oil and gas "wells";

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[4] Section 114 (b) (3) of the 1928 and 1932 Revenue Acts, Article 236 (d) of the Treasury Regulations 74, and Article 230 (d) of Treasury Regulations 77. The 1932 Revenue Act did not change the percentage depletion provisions applicable to lessors, but it added the provision that there shall be excluded from gross income subject to the 27½% deduction "an amount equal to any rents or royalties *paid* or *incurred* by the taxpayer in respect of the property" (italics ours).

it defines the deduction as an allowance for "depletion." Depletion allowances have always been recognized as representing deductions allowed to compensate the taxpayer for a wastage or exhaustion of his assets (*Helvering* v. *Falk,* 291 U. S. 183, 187–188, and cases cited). Where, as in this case, a bonus is received upon execution of a lease authorizing exploration for oil on land which is not part of a proven oil-producing tract and no steps are taken during the taxable year to bring the property into production, there is not only no depletion of the taxpayer's assets during the taxable year but it remains wholly speculative whether there ever will be such depletion. Income taxes are taxes for annual periods and, in the absence of clear indication to the contrary, the character of items as income or as deductions is to be determined by the events of the taxable year. *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, 306; *Brown* v. *Helvering,* 291 U. S. 193, 199–201. This principle reenforces the conclusion otherwise to be drawn from the face of the statute, that Section 204 (c) (2) does not authorize depletion of bonus receipts under the circumstances of this case.

The view which we urge, that a bonus cannot be regarded as within a depletion allowance unless the circumstances then existing demonstrate with reasonable certainty that there will be actual depletion, is not in conflict with the decision in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, *supra,* holding that the Revenue Act of 1918 authorizes depletion of

bonuses received by a lessor of producing property. There is a marked difference between advance payment of royalties in anticipation of further production, which is the case when a bonus is paid to the lessor of a producing or proven tract, and a bonus paid for the privilege of prospecting for oil, when there is merely a speculative possibility of success. In the former case the depletion allowance is not divorced, as it would be if permitted here, from actual depletion. The *Murphy* case decided only that a bonus *may* be subject to depletion. It did not consider or decide the question presented here, whether *every* bonus given for execution of a lease authorizing exploration for and extraction of oil is within a depletion deduction.

Petitioners (Brief, pp. 11–12, 20–21) stress the fact that the depletion deduction granted by Section 204 (c) (2) depends more upon the amount of income than upon the amount of production of oil and gas. They seem to conclude from this that the deduction is allowed irrespective of any showing of actual present or future depletion. That the substitution of percentage depletion for discovery depletion involved merely a change of basis and did not alter the preexisting conception of the theory of depletion is clear from the opinion in *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, where this Court said, p. 467:

> There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion, in-

> tended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not, and that depletion includes under the 1926 Act precisely what it included under the earlier Acts.

Accordingly we submit that there is no indication that Congress intended the allowance under the Revenue Act of 1926 to be made in a case where none would have been permitted under the prior Acts. Section 204 (c) (2) was adopted "in the interest of simplicity and certainty in administration" because of the difficulty of administering the provisions of the earlier acts permitting depletion of oil and gas wells based upon discovery value.[5] The very liberality of this deduction, which is not limited to wells where the taxpayer can establish discovery value, would seem to indicate that the words of the statute should not be extended beyond their natural meaning and that the deduction should be confined to cases where, during the taxable year, *some* present or future depletion can be demonstrated.

Petitioners also contend that Article 216 (d) of Treasury Regulation 69, and like regulations under earlier Acts, show that a bonus received in a year in which there is no production is subject to a depletion deduction. Paragraph (d) (*infra*, p. 22)

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[5] S. Rep. No. 52, 69th Cong., 1st Sess., pp. 17–18; H. Conf. Rep. No. 356, 69th Cong., 1st Sess., pp. 31–32.

provides that upon termination or abandonment of a lease without the removal of "any or all" of the mineral contemplated, the lessor shall return as income in that year his excess depletion previously allowable in respect of bonus and royalty payments over the actual depletion sustained.

Paragraph (d) is not inconsistent with the ruling in I. T. 2384 (*supra,* p. 9) that the depletion deduction allowed by Section 204 (c) (2) "in the case of oil and gas wells" makes a well a prerequisite to allowance of the deduction. The quoted phrase does not necessarily mean a producing well, and, if it does, petitioners are not entitled to the depletion allowance claimed in their 1926 return. Moreover, paragraph (d) deals with the ordinary depletion deduction based upon cost or March 1, 1913, value, and the novel form of depletion deduction based upon a percentage of income, introduced by Section 204 (c) (2) of the Revenue Act of 1926, may require a stricter construction. In addition, paragraph (d) is designed to protect the Government against possible loss of revenue, and the words "any or all" may have been inserted in an excess of caution to cover any possible contingency. We submit that these words do not affirmatively show that the Treasury interpreted the law as authorizing depletion of bonus payments when during the taxable year there was neither production upon the leased lands nor assurance of future production.

Petitioners further contend that the loss of the depletion allowance is a hardship because, if the

property eventually produces oil in commercial quantities, there will be no later opportunity to compensate them for the withholding of the allowance against the bonus. We desire to point out that, as against such immediate apparent hardship, petitioners in later years may derive advantages if their 1926 bonus income is not subject to a depletion allowance. The allowance of depletion reduces the basis for determining gain or loss.[6] *United States* v. *Ludey,* 274 U. S. 295. If no depletion is allowed against the bonus there will be no reduction of the basis, and a later disposition of the property by petitioners would result in the computation of gain or loss upon a basis more advantageous to them than if the allowance now claimed had been made.

Petitioners point out (Brief, p. 12) that under certain conditions there will be no allowance for actual exhaustion under the percentage depletion provision of the statute. However, in such cases an income deduction is permissible upon the basis of unit depletion, which is the method followed in applying Section 214 (a) (9) of the Revenue Act of 1926 and the similar provisions of later Acts.[7] This deduction is based upon cost, and every depletion allowance made reduces the balance of the cost to be returned in later years, thus diminishing

[6] Section 202 (b) (2), 1926 Revenue Act; Section 111 (b) (2), 1928 Revenue Act; Section 113 (b) (1) B, 1932 Revenue Act.

[7] Section 23 (l), 1928 Revenue Act; Section 23 (m), 1932 Revenue Act.

the depletable base.* *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, *supra*. It is therefore clear that the allowance in later years, under provisions corresponding to Section 214 (a) (9) of the 1926 Revenue Act, will be greater if depletion had not been allowed against the bonuses received in 1926.

In view of these considerations, there is no assurance that the withholding of a depletion allowance against the 1926 bonus payments will result in ultimate hardship to petitioners. Their claim of hardship is also predicated upon the assumption that there will be later substantial production and therefore depletion. We submit that this assumption rests upon a very uncertain foundation.

In the various cases coming before the Board of Tax Appeals subsequent to *Murphy Oil Co.* v. *Burnet, supra,* the Board has consistently held that, under circumstances similar to those presented here or more favorable to the taxpayer, a bonus is not subject to the depletion allowance authorized by Section 204 (c) (2). *Glide* v. *Commissioner,* 27 B. T. A. 1264; *Umsted* v. *Commissioner,* 28 B. T. A. 176; *Sneed* v. *Commissioner,* 30 B. T. A. 1121. The Circuit Court of Appeals for the Eighth Circuit, in affirming the *Umsted case, supra,* reached the same conclusion. *Umsted* v. *Commissioner,* 72 F. (2d) 328, 329.

While the general rule applicable to depletion of bonus payments has been before this Court several

* Article 216 (a), Treasury Regulations 69; Article 236 (a), Treasury Regulations 74; Article 230 (a), Treasury Regulations 77.

times, it has not heretofore had occasion to consider the limits of the rule.

Burnet v. *Harmel,* 287 U. S. 103, held that bonuses received by a landowner upon the execution of oil and gas leases were taxable as ordinary income under the Revenue Act of 1924, and not at the lower rate applicable to profits realized on the sale of capital assets. The Court, in reaching this conclusion, pointed out (p. 111) that "bonus payments to the lessor have been deemed to be subject to depletion allowances" under both the 1924 Revenue Act and earlier Acts.

Murphy Oil Co. v. *Burnet,* 287 U. S. 299, *supra,* held that, in computing the depletion deduction applicable to royalties received in 1919 and 1920 by a lessor of oil lands, the cost or March 1, 1913, value of its property should be adjusted for bonuses which it had received in prior years, since the statute and Treasury regulations (1) authorize depletion of bonus payments and (2) require an adjustment of cost or value of the property on account of depletion deductions so allowed. No question was or could have been raised as to whether or not the particular bonus payments received by the taxpayer were within the statutory allowance for depletion, because oil was being produced on its land in paying quantities before the lease in question was executed (*Murphy Oil Co.* v. *Burnet,* 55 F. (2d) 17, 19).

Palmer v. *Bender,* 287 U. S. 551, held that bonuses paid to a lessee upon execution of subleases

were subject to the depletion deduction authorized by the Revenue Act of 1921. It appears from the opinion of this Court (pp. 553–554) that there were producing wells on the property at the time the subleases were executed.

United States v. *Dakota Montana Oil Co.*, 288 U. S. 459, held that the capitalized cost of drilling oil wells is within the depletion deduction of 27½% of gross income authorized by Section 204 (c) (2) of the Revenue Act of 1926, and that therefore a corporation claiming a deduction under this section was not entitled to an additional deduction for depreciation of such capitalized cost under Section 234 (a) (8)[9] of that Act.

If this Court should adopt the view that Section 204 (c) (2) does not require a well on the lessor's land, either in existence or under construction during the tax year, but that the lessor is entitled to the deduction if the facts then existing give practical assurance of future production, the decision below should, nevertheless, be affirmed. Petitioners have failed to establish the facts necessary to bring themselves within the deduction so construed.

Petitioners received bonus payments in 1926 from 18 different lessees in consideration for the execution of at least 18 different leases (R. 21–22). The record shows that the first oil well in the Panhandle was brought into production in 1922 or

[9] This section grants corporations the same deduction allowed individuals by Section 214 (a) (9) of the Act (*supra*, pp. 3–4).

1923; that in the latter year a well was discovered about 4½ miles south of petitioners' land and another well about 3½ miles east of their land; that in 1926 the nearest well was 3½ miles away; and that the geological structure of their land is favorable to oil discovery (R. 22, 24, 27). This falls far short of establishing that in 1926 future production on any part of the land was practically assured. It falls even farther from establishing that future production on any particular lease or leases (of the 18 or more executed) was practically assured. One of petitioners' witnesses stated, "It is possible, but not probable, that there might never be any wells in the Herring property" (R. 27). The fact that until December 1932 (R. 15) only 4 wells had been drilled, involving 3 of the 18 lessees from whom bonuses had been received in 1926 (R. 21–22, 24), shows that, viewed in the light of subsequent events, future production on any particular lease or leases was not merely not practically assured; it was not even probable. The Board of Tax Appeals found that there was no production during 1926 and that there were not at that time "more than a speculative possibility of production" (R. 14).

Finally, it should be borne in mind that the rule for which we contend will ordinarily exclude only the initial bonus paid to the lessor of wildcat territory. While these petitioners received bonuses aggregating over $600,000, this total was received on account of at least 18 separate leases. The record does not disclose the bonus payments on a per-

acre basis and there is nothing to indicate that they were any greater than those usually paid the lessor of a wildcat lease. Congress had no reason to favor such lessors. They do no developing and take no risks. Discovery depletion was intended to benefit primarily the wildcatter or pioneer—the lessee of wildcat territory.[10] Discovery depletion was replaced by percentage depletion in the interest of simplicity. (*Supra,* p. 12.) It is true that, because of the statutory provision for equitably apportioning the depletion deduction between lessor and lessee, the former receives the advantage of the discovery basis, but this is wholly incidental to the primary purpose of encouraging and rewarding those who assume the risk.

CONCLUSION

It is respectfully submitted that the judgments of the court below should be affirmed.

J. CRAWFORD BIGGS,
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WILLIAM STANLEY,
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FRANK J. WIDEMAN,
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NOVEMBER 1934.

[10] S. Rep. No. 617, 65th Cong., 3d Sess., p. 6; H. Rep. No. 1, 69th Cong., 1st Sess., p. 6.

APPENDIX

Article 216 of Treasury Regulations 69 (promulgated under the Revenue Act of 1926) provides:

> (a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.
>
> (b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall

be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property.

I. T. 2384, VI–2 Cumulative Bulletin 22, provides:

> The opinion of this office is requested concerning the following portion of article 216 of Regulations 69, relative to depletion deductions:
>
> "(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property."
>
> The question is raised as to whether, under the provisions above quoted, the lessor is entitled to a deduction for depletion of 27½ percent of any amount received as a bonus for oil and gas leases or of any amount received as oil or gas lease rentals.
>
> Section 204 (c) 2 of the Revenue Act of 1926, upon which article 216 (e) is based, provides that—
>
> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."
>
> It will be noted that the above-quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from such property. Accordingly, it must be concluded that the application of article 216 (e)

of Regulations 69 is dependent upon whether or not the lease in question is of an oil or gas well, and that article 216 (e) of the regulations does not apply to leases covering properties on which no well is in existence.

G. C. M. 11384, XII–1 Cumulative Bulletin 64, provides:

> An opinion is requested relative to the application of the decision of the United States Supreme Court in the case of *Murphy Oil Co.* v. *Burnet,* December 5, 1932 (53 S. Ct. 161), to certain situations arising in connection with the allowance of percentage depletion in the case of a bonus paid for an oil or gas lease.
>
> Although the United States Supreme Court had before it in the *Murphy* case a question which arose in connection with an allowance for depletion based on cost, some of the language used by the court appears to be equally applicable to certain situations arising in connection with percentage depletion. The language referred to is as follows:
>
> "* * * when the execution of an oil and gas lease is *followed by production of oil,* the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under section 234. * * * A distinction between royalties and bonus * * * making no provision for a *reasonably anticipated production of oil* on the leased premises, would deny the 'reasonable allowance for depletion' which the statute provides. * * *"
>
> The four situations to which attention is called are as follows:
>
> (1) No oil being produced when the bonus was received, but future production practi-

cally assured because of nearby wells and geological indications.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

It is stated in substance that it is the opinion of the Income Tax Unit that a practical application of the law and the regulations in the light of language used in the *Murphy Oil Co.* case would be to allow depletion in situations (1) and (2) and to deny it in situations (3) and (4).

After consideration of the question, this office is of the opinion that the conclusion reached by the Unit is correct and should be applied in the disposition of future cases involving this issue.

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U. S. GOVERNMENT PRINTING OFFICE: 1934